COMMERCIAL LINES MARKETS
TASK FORCE
REPORT
November, 2002

INTRODUCTION

In March, 2002, the Director of the Arizona Department of Insurance (ADOI or Department), Charles R. Cohen, established a Commercial Lines Markets Task Force (Task Force). Task Force members are listed in **Exhibit 1**.

From having monitored Arizona markets, received consumer inquiries, paid attention to local and national trade reporting, and taken public comment at an ADOI hearing regarding nursing home liability (NHL) insurance availability and affordability, the ADOI became aware of the increasing volatility of Arizona commercial insurance markets. The Department's sources of information indicated that the Arizona market is impacted by national and local influences, that hard market conditions permeate Arizona's market, and that some special circumstances have contributed to an immediate crisis in Arizona's NHL market, and an impending crisis in its medical malpractice and construction defects liability markets. To further study the matter, the Director established the Task Force. The Task Force was supported and assisted by Department staff.

The Director's charge in **Exhibit 2** to the Task Force was to confirm the prevailing condition of the Arizona markets, to identify market and regulatory problems, to identify possible solutions, and to make recommendations for action. The Task Force was asked to develop a report discussing the issues and making recommendations for action, including recommendations for any proposed legislation. The recommendations of the Task Force could include, but were not necessarily limited to, recommending: amending the statutes, making administrative rules, issuing policy statements, and/or designing a new system.

In 2002, the Task Force met on April 16, June 18, July 31, October 9 (teleconference), November 6 (teleconference), and November 13 (teleconference); the agendas and minutes of those meetings are found in **Exhibit 3**. The findings and recommendations of the Task Force that resulted from those meetings follow in this Report.

About this Report: *Italicized* words are defined in the glossary in **Exhibit 4**. The Report is divided into two parts. Part I is the Task Force's Findings. The Task Force's recommendations are in Part I, Section IV of the Report. Part II of the Report presents the views of the subcommittees that assisted the Task Force in its work. The Report occasionally characterizes insurer responses to market conditions. These characterizations, when they appear, are either taken from public statements released by insurers or are inferences about insurer intentions drawn by members of the Task Force. In no case do they result from concerted actions or decisions by any insurer represented by a member of the Task Force.

PART I
COMMERCIAL LINES MARKETS TASK FORCE FINDINGS

Arizona currently has an affordability and availability crisis in NHL and problematic markets for medical malpractice and construction defects insurance as discussed herein.

SECTION I. BACKGROUND AND NATURE OF THE PROBLEM:

Most property and casualty (P&C) insurance rates in Arizona, including NHL, medical malpractice, and construction defects insurance rates, are governed by the Arizona Revised Statutes, Title 20, Chapter 2, Article 4.1, a "use and file" rate filing law (see **Exhibit 5, Open Competition,** for discussion). Although insurers, under this law, must file rates within 30 days after their effective date, they may use the rates immediately in the market. This law is based upon the premise that competition is the primary protection against excessive rates and that no rate is "excessive," as a matter of law, as long as a competitive market exists in this state for the line of insurance to which the rate applies.

A.R.S. § 20-383(B) requires the ADOI to conduct relevant market tests to determine if a reasonable degree of price competition exits. These tests consider the:

- Number of insurers actively engaged in the class of business;
- Market share and changes in market share of insurers;
- Existence of a degree of rate differentials in a particular class of business; and,
- Ease of entry and latent competition of insurers capable of easy entry.

To assist in fulfilling its obligation to monitor competition, the Department relies upon a number of sources for input including, but not limited to, the following:

- The ADOI monitors (see **Exhibit 6** for description of program) major lines of property and casualty (P&C) insurance. Factors used by the ADOI in deciding which lines of insurance to monitor include whether the line, historically:

  - Becomes unavailable or unaffordable;
  - Is sensitive to the insurance *Underwriting Cycle*;
  - Is intensely competitive and which, if the market is destroyed, could result in a monopoly;
  - Is highly vested with the public interest; and/or,
  - Is volatile and/or has a *long tail*.

  NHL, medical malpractice, and construction defects liability insurance all possess these characteristics. As a result of its monitoring efforts in 2001 and 2002 the Department learned that all of the aforementioned coverages are incurring availability and affordability problems to some degree as insurers refuse to accept new business or cancel or nonrenew existing business

- The Department's Market Assistance Plan (MAP) often provides the first indication of market difficulties. See Section III, "Voluntary Plan" for discussion.

- National trade journals provide information.

- Public hearings to obtain consumer and other interested party input about current market conditions are sometimes held. For example, perceiving that nursing homes[1] could be experiencing difficulty in obtaining liability insurance, the Director held a hearing on January 28, 2002 (**Exhibit 7** -- hearing notice) to receive public comment regarding whether insurance was unavailable or unaffordable to Arizona nursing homes. A summary of comments made by interested parties during the hearing follows:

  - Legal Climate Comments: Arizona is becoming as litigious as Texas and Florida and its legal climate deters insurers from entering the NHL market. Courts interpret Arizona's "elder abuse" law to hold nursing homes strictly liable. Arizona should limit awards. Ninety-five percent of assisted-living home claims arise because disgruntled employees of the facility complain to the Adult Protective Service (APS), and attorneys use complaints filed with APS for the purpose of creating class action suits.
  - Availability and Affordability Comments: About five insurers will write NHL for Arizona risks; but, it is doubtful, given reinsurance considerations, whether their capacity to write NHL will continue. Nursing homes are renewed with premium increases of 50% or more, with higher deductibles, and with less coverage, even if loss free. It is becoming difficult for nursing homes to obtain excess liability limits. Higher Medicaid reimbursement rates have not controlled insurance costs. Nursing homes have no reserves to pay additional premium charges, and many smaller nursing homes, are being forced out of business.
  - Additional Requirements: Prior to providing coverage, many insurers require nursing homes to meet insurer staffing requirements (e.g., some insurers require the same staff-to-patient ratio, on all shifts, for assisted living as for skilled nursing homes).
  - Senior Care: Arizona has one of the fastest growing segments of senior care. A special fund should be established to take care of patients whose nursing home care facility goes out of business.

- Producer and insurer input is invaluable in measuring competition. For example, in March, 2002, the ADOI conducted a survey of 200 admitted insurers to determine their willingness to provide NHL in Arizona. Of the 195 insurers that responded, only 24 indicated some willingness to provide a market for nursing homes, but the ADOI believes this number to be misleading for the following reasons:

  - All 24 insurers have very restrictive underwriting criteria;
  - Some only write property coverage;
  - Others write nursing homes only in conjunction with churches or hospitals also insured by them;

[1] For the purpose of the hearing "nursing home" included all of the following profit or nonprofit facilities: nursing homes providing skilled or intermediate care, or both; assisted living facilities with on-premises health care; rest homes with health care; personal care facilities or residential homes with skilled nursing or other health care; convalescent homes with continuous nursing or other medical care; continuing care retirement communities that have a nursing home on campus; or, any other adult extended care facility, by whatever name known, that provides nursing or other medical care.

- Four said they will substantially tighten their underwriting standards during the next six months to include determining whether to remain in the NHL market;
- Eight groups control 22 of the 24 insurers. Groups are given to consolidated decision-making.

The Task Force considered information gathered by the ADOI from its sources and also reviewed national and local influences impacting insurer market entry or exit. Although Arizona is not unique in having been impacted by these influences, the following are significant factors affecting Arizona's current market conditions:

A. National and Industry-wide influences: (Arizona impact appears in **bold**.)

1. Importance of underwriting and pricing discipline. **Historically, in Arizona, as well as nationally, some insurers periodically fail to exercise the underwriting and pricing discipline needed to maintain a stable and robust market.** Fundamentally, insurers must assess the risk, determine the potentiality for loss it presents, and obtain sufficient rate to cover the likelihood of loss and attendant expenses. However, during the Underwriting Cycle's *Soft Market Stage* and periods when investment return is high, some insurers, succumbing to market pressures, underprice their product to obtain or retain market share and premium cash flow.

   During favorable economic conditions, insurers often rely upon investment income returns to justify rates that would otherwise be found inadequate were investment income not considered. Arizona law, however, requires insurers to consider investment income in setting rates. A.R.S. § 20-384(B). The law also requires insurers to take into account their experience outside Arizona. Therefore, although insurers are ostensibly statutorily prohibited from charging inadequate rates, as a practical matter, while an insurer's Arizona-specific loss experience may suggest a higher rate, insurers may use investment income and a line's more favorable national experience to actuarially justify lower Arizona rates. A.R.S. §§ 20-383(A) and 20-384(B).

   Depending upon the degree of underpricing, the Soft Market's duration, and the number of competitors, a market may become impaired leading to any of the following which can create market disruptions and distortions:

   a. Insurers, unable to compete, are forced out, reducing the number of insurers selling the product and minimizing consumer options.

   b. If only one insurer willingly remains in the market, business will by default flow to that insurer permitting it to exercise *market power*.

   c. Insurers remaining in the market become very selective in their underwriting of new accounts; reunderwrite, reprice, or nonrenew existing accounts; and/or substantially increase rates.

d. Despite the profitable Arizona experience of a particular subsidiary, group holding companies may make corporate decisions to exit Arizona based on national results.

e. An underpriced line's losses may cause an insurer to withdraw from all other lines written in Arizona despite their profitability.

2. Countrywide loss and expense experience: **As most P&C insurers in Arizona are writing in multiple states, their national experience in a line often influences decisions to exit, despite their Arizona specific experience.** Insurers are required to "give due consideration to past and prospective loss and expense experience within and outside this state." A.R.S. § 20-384(B). All insurers currently writing NHL and construction defects coverage in Arizona are foreign insurers writing in multiple states. The Mutual Insurance Company of Arizona (MICA) is the only *domestic* insurer transacting medical malpractice insurance in Arizona. As MICA predominantly writes in Arizona, its national experience has minimal influence on its Arizona business.

3. Reinsurance unavailability and unaffordability: **The availability and affordability of reinsurance to insurers directly impacts the availability and affordability of coverage to Arizona consumers.** Reinsurance is insurance coverage purchased by insurers to limit their exposures to losses under policies they have issued. It often provides them with *capacity* to write more insurance than their financial position would otherwise permit them to write. Since September 11, 2001 (9/11), insurers have experienced increased difficulty obtaining reinsurance as reinsurers have: increased pricing; restricted coverage terms, conditions and/or limits of liability; limited the types of risk they will assume, or refused to provide reinsurance for a particular product or line. While the realization of terrorism-related exposures is the "straw that broke the camel's back," reinsurers now exhibit a reduced appetite for other types of risks as well. Although national in scope, Arizona is impacted, and the Director has urged Arizona's congressional delegation in a series of letters (**Exhibit 8**) to support federal legislation that would ensure the availability of reinsurance for terrorism-related exposures.

4. Reduced investment income: **Less investment income, coupled with the onset of the Hard Market, caused many insurers to review their Arizona rates as many can no longer depend upon investment income to cover underwriting profitability shortfalls**. In the past decade, most insurers had more than an adequate return on investment income, but a slow down in the US economy and the impact of 9/11 changed this. The total return on investment portfolios has declined and is generally related to poor stock performance and declines in interest rates, which dropped to near-historical lows. Poor *combined ratios* no longer could be offset by investment income. For example, the industry-wide 2001 combined ratio was 153.3% for medical malpractice (i.e., for every $1 in premium received, insurers

paid out $1.53) and 122.2% for other liability (in which line some insurers report experience for construction defects and NHL).[2]

5. Consolidations and Consolidated-Decision Making: **It is common for holding companies to make the decision to exit for all subsidiaries writing insurance in Arizona.** Large company groups now dominate many national P&C lines, making their perspective national rather than regional. The past decade's flurry of acquisitions and mergers eliminated a number of independent competitors. Some smaller insurers, suffering from the effects of sustained underpricing, were acquired by larger, more efficient companies. Others merged in an attempt to become more efficient or to remain an ongoing business concern. The result has been a consolidation of business within large holding companies and the emergence of very large groups that control many insurers. Holding companies that have acquired or merged insurers often find that integration risk poses challenges for management teams searching for new expense synergy, products, and distribution channels that affect market strategy. The business of an acquired or merged insurer, therefore, may be reunderwritten, redistributed or nonrenewed, completely changing the composition of the business previously written by that insurer. Often the same group decision may impact the degree of market participation by all subsidiaries.

B. Local Influences: A number of local factors can have an impact on the Troubled Markets. The Task Force's conclusions regarding their impact appear in **bold.**

1. Litigation: Due to increased costs and loss unpredictability, some insurers tend to increase rates, or restrict their coverages, or simply decline to do business, in jurisdictions in which they perceive significant litigation-related exposures. Depending on the insurer, relevant considerations may include:

- The perceived litigiousness of the local culture.
- The perceived fairness and efficiency of the local judicial system.
- Whether state law provides limitations for awards of non-economic damages, punitive damages, and attorneys' fees awards in personal injury actions.

The Task Force believes that litigation issues are a contributing cause, but not the sole cause, of hard liability insurance markets in Arizona, and that "tort reform" in Arizona would not, by itself, entirely solve all the problems of the liability insurance markets. **The Task Force does conclude that litigation issues do have an impact on the health and functioning of the liability insurance markets and recommends that elected policymakers interested in improving the liability insurance markets in Arizona consider the issue of tort reform, generally and specifically, along with other potentially remedial measures.** The Task Force understands that change in this area may require amendment to the state constitution, and that there are many models and variations of tort reform, many debatable points, and many interests to balance. This Task Force was not assigned

[2] Best's Aggregates & Averages, Property-Casualty, 2002 Edition, pp 420 and 438.

to, and did not purport to, study this complex and fundamental policy issue in depth, and does not presume to recommend specific policy or action in this area.

2. Loss Control Climate: Loss control, a necessary part of a proactive risk management program, is the process by which training, safety, and security measures will reduce loss frequency and severity. Factors that can impact the loss control climate of a state and encourage insurers to write business include:

- Whether insurance producers actively help insureds prevent losses and control insurance costs. Some large producers have loss control departments staffed by qualified professionals who perform safety inspections and assist clients with improving their loss experience.

- Whether loss control technical assistance exists in the state that will permit insurers to outsource inspections to a consultant.

- Whether the intended customer base has in-house loss control resources or ready access to outside risk management expertise.

- Whether programs exist in the public and private sectors of a state to provide information, encouragement and assistance to focus the attention of commercial insurance consumers on the benefits of maintaining safety and quality standards and reducing errors and claims.

- Whether problems, in general, associated with the availability and affordability of healthcare and healthcare financing impact the quality of medical care and, consequently, medical malpractice insurance losses.

While recognizing that there are difficulties in measuring the effectiveness of loss control programs, the Task Force believes that efforts can and should be made to encourage sustained and improved procedures to control losses, such as:

- **Each affected industry should utilize its trade associations, or otherwise organize itself, to proactively provide leadership, education and assistance to its members in the areas of loss control, risk management and safety.**
- **Each affected industry should pursue and foster collaboration with their liability insurance industry and with their occupational regulators to provide such education and assistance to its members, particularly education.**
- **The ADOI should use its website to provide members of the affected industries with access to information concerning such education and assistance opportunities.**

3. Regulatory Climate: The regulatory climate can affect insurance markets in the following ways:

a. The quality and effectiveness of the system for regulating the businesses, professionals, and occupations to be insured. For example, nursing homes, doctors, and contractors are all regulated by various state boards and/or agencies. These

businesses and/or professionals must meet certain state requirements to be licensed as well as to stay in business. The adequacy and appropriateness of the applicable regulatory standards, the adequacy of public regulatory resources, and the effectiveness with which the public regulatory system is implemented all contribute to the actual and perceived climate for loss control in the locale.

b. The quality, efficiency, and effectiveness of the local insurance regulatory system. The type of insurance laws a particular state has and the manner in which those laws are administered by the local regulatory authority impact competition and the time and cost required for insurers to get their products to market. While an appropriate and efficient insurance regulatory system probably would not, alone, attract an insurer to a market, a problematic insurance regulatory system could be another factor weighing against an insurer's participation in that market.

1) Insurance laws. Prior to entering a state, insurers often assess the state's laws to gauge whether its laws may impede their ability to react to market conditions or to predict losses. Insurers prefer to transact insurance in states that have insurance laws permitting them to get their products to market faster to meet competitive pressures, market changes, and consumer needs. Arizona's "use and file" rate law does this by allowing insurers to use their rates immediately without first having to file them or receive the ADOI's approval. Further, the law permits the Director to issue an order exempting from filing requirements certain rates and forms, which, in his opinion, are not necessary for the protection of the public. The ADOI's current exemption order[3] does not exempt from filing rates and forms issued to hospitals and other health care organizations or involving medical malpractice insurance. However, coverage for nursing homes and for construction defects is contained within other lines of insurance that do possess a rate and form filing exemption under the Order.

2) Administrative efficiencies. The ADOI has worked diligently to standardize filing forms, checklists, and procedures to simplify the administration of the filing and licensing processes. The ADOI recognizes the effect regulatory delay can have on the ability of insurers to compete and that delays affect the ability of products and services to be sufficiently responsive to consumer needs. The efforts of the Department to date include, but are not limited to:

- Implementation of the System for Electronic Rate & Form Filing (SERFF). SERFF, a National Association of Insurance Commissioner's (NAIC) sponsored project, is intended to provide efficiency through technology relating to the rate and form filing process. SERFF enables insurers to submit rate and form filings electronically to state regulators and enables regulators to facilitate the management, analysis, disposition and storage of filings.

- Implementation of standardized checklists and filing transmittal forms. The ADOI is working with the NAIC and insurers to develop standardized transmittal forms and checklists to be used by insurers throughout the country to make filings. These forms provide insurers with prior knowledge of

[3] Docket No. 01A-215-INS. Order issued October 26, 2001.

filing expectations in each state and augment the entire speed to market process.

- Implementation of the Uniform Certificate of Authority Application. The ADOI has adopted the NAIC's Uniform Certificate of Authority Application used by most insurance regulators and has streamlined its application process by eliminating non-uniform, state-specific application requirements and procedures. These measures support the ADOI's mission to encourage competition in the Arizona market.

The Task Force is confident that Arizona's insurance regulatory system is not a contributory cause of the hardening of the commercial insurance markets' hardening in Arizona. **The Task Force recommends that the Department continue its work to modernize and streamline state insurance regulation, and that elected policymakers continue to support those efforts and to support adequate funding of the Department to perform this work effectively.**

4. Business and Insurance economic opportunity climate: Prior to entering a market, insurers consider a state's general economic condition and whether the state provides an appealing economic environment in which to conduct business. The Task Force believes that the medical malpractice insurance markets may be adversely impacted by Arizona's large migratory and uninsured population which adds stress to the healthcare system.

Other than as stated above with regard to the healthcare system, the Task Force does not perceive that there are uniquely unfavorable economic conditions in Arizona contributing to the hardening of the Troubled Markets.

SECTION II. ACTIVITIES OF THE TASK FORCE.

The Task Force resolved that although other lines of insurance in the Arizona commercial lines market are experiencing problems identified with the Hard Market, the affected lines having the most adverse public impact are: NHL, medical malpractice insurance, and construction defects liability insurance. Therefore, the Task Force chose to focus its efforts on them. For each line experiencing difficulties, the Task Force formed subcommittees to study each topic in more depth and to present reports to assist the Task Force in performing its mission. Key findings of the subcommittee reports are blended into Section IV of this Report. Those serving on the Troubled Markets subcommittees were:

Nursing Home Liability	**Medical Malpractice**	**Construction Defects**
Tommy Gee, Chair	Ron Malpiedi, Chair	Curtis Anderson, Chair
Chuck Colburn	Curtis Anderson	Joni Fairbrother
Lanny Hair	Chuck Colburn	Tommy Gee
Gary Tiepelman	Peter Gorman	Jack King
	William Jones	Gary Tiepelman
		Mark Webb

To gather additional information, the Task Force heard from the following:

- Deloris Williamson, Assistant Director, Rates & Regulations Division, ADOI, made power point presentations (**Exhibit 9**) on April 16 and June 18, 2002 regarding the current statutory system for rates, a Consumer Advisory Board, a JUA, and an ARP.

- Charles Devlin, CIC, ARM, of Aon Healthcare Alliance, made a power point presentation (**Exhibit 10**) on July 17, 2002 regarding medical malpractice. His major points about medical malpractice insurance were:

  - Reinsurance and capacity are problematic for insurers. This has forced some hospitals, for example, that formerly had $100,000 deductibles to take large self-insured retentions of a $1,000,000 or more because insurers find it easier to write insurance above a higher *self-insured retention*.

  - Physicians and surgeons, practicing defensive medicine to avoid lawsuits, may order additional and sometimes unnecessary medical tests which has increased costs an additional $50 billion a year.[4] Further, many physicians are refusing to practice in high-risk specialties. Rural areas, in particular, are finding it difficult to retain physicians and surgeons. Obstetricians are dropping their OB exposure and practicing only gynecology. This is forcing expectant mothers to drive to large cities to deliver babies.

  - As reported in the Aon Physician Alliance Risk Advisor, Volume I, Issue I, the following are noteworthy:

    - One out of every 12 doctors nationally is sued annually.
    - The average jury award nationally has increased significantly ($3.49 million in 1999 versus $1.95 million in 1993).
    - The median award,[5] as is the total award[6] payout, for states having caps (20 states) on non-economic damages is, on the whole, substantially lower than the median awards for states that do not cap awards (30 states). For example, California, a state having a $250,000 limitation, had awards totaling $200,832,512 in 2000 and a median award of $55,000. New York, however, a state without caps, had the most total awards in the nation, $632,996,221, and a median award of $150,000 for the same period. Arizona, a state without caps on payments had jury awards totaling $68,920,261 in 2000 and a median award of $150,000. Arizona ranks, by total awards, in fifteenth position among the 30 states that do not cap awards (**Exhibit 11**).

  - In a market like the current medical malpractice market, more business is driven out of the traditional insurance market to *captive insurers*. As former policyholders with better loss experience form their own captives and exit the traditional market,

[4] Aon Physician Alliance Risk Advisor, Volume I, Issue I, summer 2002.
[5] The median amount is the 50th percentile of all medical malpractice payments made by individual physicians in these states in 2000.
[6] The total award is the aggregate amount of dollars paid out by insurers to cover medical malpractice jury award losses in 2000.

remaining policyholders in the traditional market tend to present higher risks and have poorer historical loss experience, thus causing their rates to significantly increase or causing insurers to be unwilling to write them.

- The market started to harden three-years ago, thus, prior to 9/11.

- James Hurley, ACAS, MAAA of Tillinghast-Towers Perrin (TTP) made a power point presentation (**Exhibit 12)** regarding medical malpractice. During his presentation, Mr. Hurley said that:

- Using the national data from insurers' annual statements filed with regulators through 2001, TTP studied seven-years of calendar-year results of approximately 30 current or former members of the Physicians Insurers Association of America (PIAA). PIAA companies predominantly write physicians and surgeon's coverage, represent about one-third of the data reported to AM Best, have approximately $7 billion in reserves, write about $3 billion in premium, and are mostly monoline medical malpractice insurers writing most of their business in their states of domicile. MICA results were included in the study. Mr. Hurley said that a reason for today's problems is that a number of insurers, including some in the survey, went into states about which they had incomplete information, competitively priced their product in a soft market, incurred large claims, and found they had inadequate rates. Mr. Hurley said insurers, such as MICA, that have confined their writings to their domiciliary state have historically had better results.

- TTP found that in the early part of the review period medical malpractice was profitable. However, the combined effect of less investment income, together with the deterioration in the combined ratio, produced a -10% loss (net income as a percent of premium) toward the end of the review period. In 2001, MICA, with a 14% profit, did considerably better than the national average.

- Due to the line's long-tail, the loss development of medical malpractice insurance claims is challenging to predict. Assuming that it is properly establishing its case reserves, an insurer, on a claims-made book of business, can obtain a reasonable idea of where it stands at the second or third year of loss development. However, depending upon the jurisdictions in which the insurer operates, it takes five to ten years, even on a claims-made basis, to settle claims. Even with this complication, medical malpractice insurers, on the whole, had more favorable loss development than anticipated through 1999, but the loss experience deteriorated during the last part of the review period. In the aggregate, insurers reporting to AM Best, including the surveyed insurers, are now strengthening reserves. Loss severity appears to be the driver of the higher loss ratios (frequency has remained relatively stable). In particular, severity is increasing due to large awards resulting from suits. Large awards affect claims settlements because insurers tend to settle claims at higher values to avoid court which also has the effect of increasing insurance rates. As losses increase, insurers need to increase reserves. Many people believe that the claims reserve position of the industry, as a whole is probably currently deficient. Deterioration in reserves has a very rapid effect on surplus. For example, a 10% decline in reserves translates into an approximate 20% decline in surplus for the surveyed insurers because these insurers have about $2 of reserves for every $1 of surplus.

- The combined ratio (the sum of the expense ratio and the loss ratio -- excluding dividends) of the PIAA companies was below 115% through 1999, but increased to 124% in 2000 and 138% in 2001. Medical malpractice insurers cannot "make ends meet" at a sustained combined ratio in the range of 140%. The combined ratio for medical malpractice insurers as a whole is estimated to be 145%.

- Lower interest rates are affecting financial results. The delay between when the insurer collects premium and ultimately pays out claims makes it is extremely difficult for an insurer to determine what it should charge as an adequate insurance rate. However, this delay allows insurers to invest these funds during this time. Therefore, insurers earn investment income, which can be viewed as providing a "shelter" to offset insurance rate shortfalls. Mr. Hurley said that the key question at this time is: "How much protection is investment income currently providing insurers to offset a deteriorating combined ratio?" Financial results for the PIAA companies indicate that the pre-tax investment income "shelter" is about 31% in 2001 (investment income as a percentage of premium). The amount invested by them in the stock market is only about 15% of their assets; MICA has about 10%. When stocks go down, surplus and the capacity to write business decrease. Although they may have some stocks, most PIAA insurers primarily invested in bonds prior to the recent decline in interest rates. They are now rolling out of these bonds and reinvesting at considerably lower interest rates. As the investment shelter declines prospectively due to lower interest rates, insurers no longer can rely upon investment income, to the extent historically, to offset their need to increase insurance rates. If they increase rates, their asset base should remain relatively stable. Mutual insurers were paying 8-9% in dividends to policyholders, but that payout has declined to 3%. When mutual insurers pay dividends, they are, in effect, reducing rates if they actually pay the dividend as a credit against premium. By paying fewer dividends, mutual insurers, in effect, can increase their rates.

- "Leverage" is the amount of risk insurers have in their insurance portfolios relative to their surplus, which is the insurers' capacity to take on that risk. This drives the availability of insurance. The question is: How much surplus do insurers have to protect themselves from inadequate insurance rates? PIAA insurers wrote about 50¢ of premium for every $1.00 of surplus during this period, giving them a premium to surplus ratio of .5 to 1, a fairly low leverage ratio. MICA's premium to surplus ratio was even more conservative at .25 to 1. At the end of the period, the leverage ratio increased indicating insurers were in a riskier position, had less capacity, and were, therefore, in a poorer position to write new business. Overall, insurers' ability to absorb inadequate pricing is deteriorating for reasons already discussed. PIAA companies are now writing at 70¢ of premium for every $1 of surplus; MICA is writing at 40¢ for every $1.

- Connie Wilhelm, Executive Director of the Arizona Homebuilders Association (AHA), addressed (**Exhibit 13** for her written comments) the Task Force on July 31, 2002 regarding contractors' problems in currently obtaining construction defects coverage. The AHA has approximately 900 members of which one-third are general contractors and the rest are subcontractors. Ms. Wilhelm said:

  - Custom builders have informed AHA that the only choice they have for insurance currently is Maryland Casualty Insurance Company. However, a Task Force member commented that as of early July, 2002 that company is no longer writing construction defects insurance.

- Although they may not have had claims, building contractors that still have insurance are experiencing rate increases ranging between 300-400%.

- Subcontractors have a more difficult time finding insurance than general contractors who may have large national insurance programs. Task Force members commented that: in the surplus lines market, at least, insurers are more willing to write general contractors as many transfer their risks to their subcontractors; that residential and not commercial contractors are facing insurance availability problems; and, that attorneys are advising their contractor clients to separate their residential and commercial activities by creating totally separate entities so that there are no overlapping operations between the two.

- The AHA presents loss control workshops and seminars to builders.

- The AHA supported HB 2620, which, in addition to notice requirements previously discussed, permits the seller to inspect the dwelling to determine the nature and cause of the alleged defects and the extent of any repairs or replacements necessary. The seller may offer to repair or replace any alleged defects. In any contested action, the court is required to award the successful party reasonable attorney and expert witness fees and taxable costs. Ms. Wilhelm said HB 2620, although not as comprehensive as wished, is substantially better than other states' recently enacted laws. She suggests legislation limiting the amount for which one may sue, requiring additional disclosures to subsequent buyers, and providing other provisions limiting a builder's exposure to suits.

- The AHA has provided to escrow agents for distribution an AHA-developed pamphlet entitled "What Everyone Should Know About Construction Litigation."

SECTION III. THE TASK FORCE CONSIDERED EXISTING LAW TO ADDRESS THE TROUBLED MARKETS' PROBLEMS.

The Task Force reviewed existing Arizona laws that, at first glance, appear to offer some solutions, but the Task Force ultimately concluded that most were either problematic or did not offer a meaningful solution for the Troubled Markets. Specifically, the Task Force considered laws that establish the following entities or systems intended to address market insurance availability and affordability problems (Task Force conclusions appear in **bold**):

A. Consumer Advisory Board (Board). A.R.S. § 20-400.08 permits the Director to appoint a seven-member board composed of agents, brokers, and consumer representatives to advise and counsel him on market conditions, competition, and compliance. Although denominated as the "Consumer Advisory Board," this mechanism relates statutorily to insurers' compliance with filed rates, and not "consumer" issues in the sense commonly understood. The law does not provide for insurance company membership. The Board has rarely been activated, and the Director has discretion in any case to create a task force, advisory board, or committee on any subject, including consumer assistance issues, with appropriate membership for the subject at hand. It is probable that the ADOI will receive at least as much information concerning levels of competition and

compliance issues from its own market monitoring activities and by considering what types of risks may be written as surplus lines[7] than it would through the activities of the Board, as constituted by this statute.

The Task Force concluded that the Board would not be helpful in addressing the current crisis in the Troubled Markets and that A.R.S. § 20-400.08 should be repealed.

B. Assigned Risk Plan (ARP). All insurers writing either workers' compensation (WC) or automobile insurance in Arizona are required to participate in an ARP pertaining to those lines of insurance. A.R.S. §§ 23-1091and 28-4008. The aforementioned ARPs have systems, established over time, that permit them to operate efficiently. Per A.R.S. § 20-395, formation of an ARP for any other line of insurance is voluntary on the part of insurers. This law states, in its entirety:

> Insurers may make agreements among themselves with respect to equitable apportionment among them of insurance which may be afforded applicants who are in good faith entitled to but who are unable to procure such insurance through ordinary methods, and such insurers may agree among themselves on the use of reasonable rate modifications for such insurance, with all such agreements and rate modifications subject to the approval of the director.

While A.R.S. § 20-395 presents a legal foundation for the creation of an ARP for the Troubled Markets, the Task Force rejected an ARP for the following reasons:

1. The law does not provide specific guidance for establishment and administration of an ARP.

2. Few insurers would voluntarily participate in any ARP as ARPs are, by design, the market of last resort for high-risk applicants who cannot find any insurer voluntarily willing to provide coverage. The Task Force has no reason to believe that insurers, unwilling to singly provide coverage voluntarily, would be any more willing to voluntarily provide it in collaboration with other insurers. It is even more improbable that insurers would voluntarily participate in a Troubled Markets ARP due to the long-tail, the likelihood of severe claims, and the unpredictability of future loss development associated with risks written in those markets.

3. Lack of statistical credibility due to loss volatility and an insufficient number of risks would hamper development of appropriate ARP rates for rate-making purposes.

4. The formation of an ARP under a general statute like A.R.S. § 20-395 may leave anti-trust exposures and unresolved issues for participating insurers.

The Task Force concluded that the difficulties of establishing an ARP and obtaining a consensus among insurers to voluntarily participate outweigh any benefit gained by attempting to implement an ARP for any of the Troubled Markets.

[7] Surplus lines insurers do not have an Arizona license, but are authorized to write certain lines of coverage and/or types of risks if, after a hearing, the Director determines that the lines or types are substantially unavailable from insurers having a certificate of authority to transact insurance in Arizona and the particular surplus lines insurer electing to provide coverage appears on the Director's list of surplus lines insurers authorized to provide the coverage.

C. Voluntary Plan (VP). Per A.R.S. § 20-2201(A), if the Director finds, after a hearing, that a liability coverage is not readily available in the voluntary insurance market and that the public interest requires availability, he may request insurers and producers to prepare or assist in the preparation and administration of a VP to facilitate placement of coverages in the voluntary insurance markets. A VP is to consider all of the following issues, most of which were studied by the Task Force as reflected in this Report:

- The need for adequate and readily accessible coverage;
- Alternative methods of improving the market affected;
- Inherent limitations of providing coverage;
- The need for reasonable underwriting standards;
- The requirement of reasonable loss prevention measurers; and
- Plans to establish procedures that will encourage the use of the voluntary market as a condition of placement of coverage through the plan.

The ADOI currently operates a VP known as the Market Assistance Plan (MAP) pursuant to A.R.S. § 20-2201. The ADOI's MAP maintains a list of producers and insurers willing to assist with and write difficult-to-place insurance. Inquiries to the MAP regarding medical malpractice and NHL insurance availability, in particular, significantly increased during fiscal year 2002 over the prior year (NHL: three calls FY 01, 14 calls FY 02; medical malpractice: 14 calls FY 01, 36 calls FY 02).

The Task Force reviewed alternatives to the ADOI's MAP including VPs in other states which requires administrative and producer review of insurance applications and their presentation to voluntarily participating insurers. While this model would create more operational levels to be administered, it would not, in the opinion of the Task Force, provide a distribution or underwriting system that would increase coverage availability or address affordability issues in the Troubled Markets. The Task Force believes new insurers would not be attracted to a VP, and that a VP, which includes producers, would not be viable due to compensation issues.

Therefore, the Task Force believes it would be more effective to enhance the ADOI's current MAP to improve consumer education, provide direction to consumers needing it, and facilitate coverage placement, as shown in Exhibit 14, including:

1. **Making the MAP more web-based to serve as the fulcrum for the program by adding the information described in Exhibit 14 to its website to better assist all consumers, but particularly those in the Troubled Markets;**

2. **Establishing a Producer's Advisory Council to assist consumers with finding insurance, to help train ADOI personnel to ensure knowledgeable referrals, to coordinate ADOI-sponsored Consumer-Education Seminars, and to perform other tasks as more fully described in Exhibit 14;**

3. **Sponsoring Consumer-Education Seminars;**

4. **Establishing a Loss Control Advisory Committee to participate in Consumer-Education Seminars, develop consumer-assistance information, and provide input on loss control issues; and,**

5. **Enhancing its Hot Line to enable more thorough assessment of consumer's needs, follow-up with consumers and further assistance if necessary, and referral of consumers to Producer Advisory Council if warranted.**

D. Joint Underwriting Association (JUA). The Task Force spent a significant amount of time considering the attributes of a JUA pursuant to Title 20, Chapter 12, Article 1. A JUA may be operated only if the Director finds, after a public hearing, that liability insurance is substantially unavailable through private insurers for the particular line, and a VP would fail to provide coverage. **Exhibit 15** discusses in detail how the statute requires the JUA to operate. Ultimately, the Task Force rejected recommending activating a JUA for any of the Troubled Markets for the following reasons.

1. Many perplexing and unresolved issues are present in the JUA law, but four fundamental issues, about which the ADOI has asked the Attorney General's (AG) office for legal guidance, preclude implementing the system unless and until resolved.

a. Is the statute constitutional? In 1987, the AG opined (Opinion I87-037) that a similar statute creating a JUA for midwives would be found unconstitutional by a court because it created a corporation, funded indirectly by the state, that was not subject to the restraints imposed on state agencies or insurers. In formulating his opinion, the AG relied upon *Fireman's Fund Insurance Co. v. Arizona Guaranty Association*, 112 Ariz. 7, 536 P.2d 695 (1975) in which the Arizona Supreme Court held that although the legislature has authority to create various boards, etc., each must be "governed and controlled by public officials." Although the JUA statute was amended thereafter in an apparent attempt to cure its constitutional defects, the Task Force questions whether the amendments accomplished a substantive cure.

b. What public process laws (e.g., fiscal controls, procurement, open meeting) apply to the JUA? If the JUA operates as a public entity, as is apparently required to meet the requirements of the state constitution, then the practical question becomes: is it feasible to run the JUA as an effective insurance operation? The Task Force believes it is not. Task Force members who served on the medical malpractice joint underwriting plan (MMJUP) between 1976 and 1981 commented that administering the MMJUP was a "nightmare" as it was initially subject to many restrains and requirements imposed upon pubic entities. The JUA law presents a paradox in that apparently it must operate as a public entity to be constitutional, but must also operate as the equivalent of a private insurer to be feasible.

c. What is the assessment base and do permissible assessments and policyholder surcharges provide sufficient "surplus" for sound fiscal operations? The assessment base in the JUA statute is tied solely to "liability," not "casualty" premiums. However, "liability" is defined as a mere subset of "casualty" insurance. A.R.S. § 20-252. Liability premium based assessments for a JUA, based on 2001 figures, would develop only $5,719,595 whereas casualty premium based assessments for the same period would develop almost $29 million.[8] The Task Force agreed that it would take a great deal of time and effort to establish and maintain a

[8] Pursuant to A.R.S. § 20-2212, assessed insurers would be entitled to recover the amount of any JUA assessments through premium tax offsets over a five-year period.

JUA that, in the final analysis, would likely have insufficient surplus to operate safely given the statutory limitations on assessments.

d. What legally happens if all possible funding is exhausted and the JUA becomes insolvent? The JUA is to notify the Director 180 days in advance of a possible deficit and to provide him with a plan of surcharges and assessments intended to correct the problem, but the law is silent as to what the Director must do should the plan be inadequate to cure the deficit. (See paragraph c. immediately above.) It appears the insolvent JUA's obligations would fall to the State.

2. Ratemaking for the JUA would be extremely difficult. As the surcharge/assessment limitation may be insufficient to cover JUA shortfalls, the JUA must initially and consistently charge sufficient rates to avoid deficits. However, as projecting the total obligations the JUA may incur is difficult, particularly for long-tailed lines, the determination of what is a "sufficient" rate becomes highly complex and problematic.

3. The consensus of the Task Force was that separate JUA's would have to be created to service each line of insurance, creating a complicated, burdensome and bureaucratic system to administer.

4. It does not appear than any of the Troubled Markets has reached the level of "unavailability" needed to activate the JUA as a matter of law.

The Task Force concluded that establishment of a JUA, under existing law, including the state constitution and state court decisions, would be highly bureaucratic and problematic and not likely to provide a viable insurance market for any of the Troubled Markets without significant financial exposure to the State.

E. Reversion to a rate filing prior approval system. Arizona law presumes that no rate is excessive as long as price competition exists; but, if certain statutory conditions are met and competition ceases, the law provides a process for the Director to revert the "use and file" statutory filing scheme to a "prior approval" system. The Task Force discussed the diminishing number of insurers offering coverage in the Troubled Markets and their significant premium increases. (See **Exhibit 5**, Open Competition, for details.) Given the aforementioned, revision to "prior approval" is a possibility. However, the Task Force believes that reverting to "prior approval" would not be advisable because:

1. It is probable that even more insurers would exit as they no longer would have the option of immediately using a new rate that more accurately reflects changing market conditions and/or loss experience, and would face a greater regulatory burden in getting their products to the marketplace.

2. A prior approval system is burdensome to administer and would require increased ADOI staffing to effect filing review and approval. Actuarial issues underlying product filings can be very complex and debatable. The ADOI would be challenged to prevail in such matters if they became disputed. Filing backlogs are commonplace in jurisdictions with such laws.

3. Latent insurers that could otherwise immediately enter the Troubled Markets under the "use and file" system may decide not to enter.

The Task Force concluded that reverting the use and file system to a prior approval system would create more problems for the Troubled Markets than it would solve and rejected recommending to the Director that he hold a hearing to determine whether competition exists in the Troubled Markets.

SECTION IV. TASK FORCE RECOMMENDATIONS:

Having considered existing law together with local issues associated with the Troubled Markets, the Task Force draws the following conclusions and/or makes the following recommendations regarding each.

A. Existing Law:

1. **The Task Force recommends that the Legislature consider repealing A.R.S. § 20-400.08, the Consumer Advisory Board.**
2. **The Task Force concluded that the difficulties of establishing an ARP and obtaining a consensus among insurers to voluntarily participate outweigh any benefit gained by attempting to implement an ARP and, therefore, rejected recommending to the Director that he activate an ARP for any of the Troubled Markets.**
3. **The Task Force recommends that the Legislature consider revising the JUA law to resolve fundamental issues and to make it workable.**
4. **The Task Force concluded that reverting the use and file system to a prior approval system would create more problems for the Troubled Markets than it would solve and rejected recommending to the Director that he hold a hearing to determine whether competition exists in the Troubled Markets.**

B. Local Issues:

1. **The Task Force concludes that litigation issues do have an impact on the health and functioning of the liability insurance markets and recommends that elected policymakers, interested in improving the liability insurance markets in Arizona, consider the issue of tort reform, generally and specifically, along with other potentially remedial measures.**
2. **While recognizing that there are difficulties in measuring the effectiveness of loss control programs, the Task Force believes that efforts can and should be made to encourage sustained and improved procedures to control losses, such as:**
   - **Each affected industry should utilize its trade associations, or otherwise organize itself, to proactively provide leadership, education and assistance to its members in the areas of loss control, risk management and safety.**
   - **Each affected industry should pursue and foster collaboration with their liability insurance industry and with their occupational regulators to provide such education and assistance to its members, particularly education.**
   - **The ADOI should use its website to provide members of the affected industries with access to information concerning such education and assistance opportunities.**

3. **The Task Force recommends that the Department continue its work to modernize and streamline state insurance regulation, and that elected policymakers continue to support those efforts and to support adequate funding of the Department to perform this work effectively.**
4. **The Task Force recommends the ADOI enhance its MAP, as described in Exhibit 14 and Section III(C) of this Report.**
5. **The Task Force recommends that the ADOI continue its customary practice of considering, at least within every two-year period, whether its current form and rate filing exemption order should be amended in light of prevailing market conditions.**

PART II
SUBCOMMITTEES' VIEWS AS TO THE TROUBLED MARKETS

The Task Force received and considered reports from subcommittees regarding each segment of the Troubled Markets. A synopsis follows of the various subcommittee's views, conclusions, and comments.

Section I. NHL: For purposes of this Section, the Subcommittee defines "Nursing Home Liability" as general and professional liability necessary to operate Skilled Nursing Homes, Assisted Living Facilities and Adult Care Homes. For the remainder of this Section, the Subcommittee will refer to this group of care providers as “Nursing Homes,” but will make specific references when appropriate. The NHL Subcommittee's full report is found at **Exhibit 16**. The NHL Subcommittee found the following:

A. National and Industry-Wide Influences on NHL: Nationally, there has been a NHL crisis for some period that has also impacted how insurers react in Arizona. In the past, liability was written by a large number of insurers operating either on a national or regional basis whose profitability in this class was sufficient to make availability and affordability of NHL insurance a non-issue. Approximately, five years ago events began to occur that would change this including, but not limited to the following:

- More nursing homes as well as assisted living facilities were created to address the needs of the nation's aging population.
- Insurance companies began to incur losses that were not just the occasional “slip and fall,” but that involved more complicated and costly “quality of care" or wrongful death issues. Previously, claims were limited and were primarily settled for economic damages.
- The "economic value" of a nursing-home resident's life increased. Historically, the economic value of the life of a typical nursing home resident, ages 80 to 100, was not considered high. However, as juries (particularly in Florida, Alabama, Louisiana, and Texas) began to grant large monetary awards for non-economic and/or punitive damages, the economic value of the aged increased.
- Successful suits against nursing homes throughout the country attracted the attention of the plaintiff's bar. Factors that determine states in which suits most probably will be brought are: a particular state's laws, a state's legal environment, the degree to which punitive damages are permitted, and the percentage of elderly residing in the state.

Overall, the current national NHL situation is that insurance premiums are increasing at a dramatic rate due to insurers' unfavorable loss ratios and the unpredictability of future losses. Reinsurance is also problematic for insurers thereby limiting the capacity of many to take on additional risk. This situation has caused many owners of facilities to file bankruptcy or has forced them, where permitted by law, to accept lower coverage limits and/or higher deductibles.

Some states that have taken action including, but are not limited to, the following:

- Arkansas: In an Arkansas Department of Insurance (DOI) hearing, insurance and nursing home representatives testified that NHL coverage was not readily available in Arkansas and called for tort reform. In response to coverage unavailability, the Arkansas DOI attempted to establish a self-insurance pool; but, its implementation has been stalled, as an insufficient number of nursing homes will commit to participate in the self-insurance system to make it financially sound. The Arkansas commissioner concluded that the DOI would not take a position on tort reform.[9] Insurers remain unwilling to return to the Arkansas NHL market.[10]

- Florida: Skyrocketing premiums have caused many nursing homes to close. Trial lawyers allege that nursing home staff negligence and incompetence are prevalent and thus inspire high rates. Nursing homes argue that Florida law encourages lawsuits and has allowed lawyers to score huge court victories. Insurers have all but withdrawn from the Florida NHL market. Remaining insurers are substantially increasing rates. For example, when one Florida nursing home's previous insurer exited, the nursing home's only choice was to obtain coverage from another insurer at premiums 250% higher than what it had been paying.[11] In February, 2002, the Florida legislature enacted a law that capped damages, made it more difficult for residents or their families to prove negligence, and required more staff in nursing homes.[12]

- Pennsylvania: Although Pennsylvania NHL experience has not been poor, many insurers have exited while those that have elected to stay have substantially raised prices. In 2001, seven insurers wrote 18 different plans for nursing homes. Currently, only three insurers remain, and they only write three plans.[13]

Certain NHL market segments are in worse condition than others:

Skilled Nursing Home Liability Market. A severe availability/affordability problem exists in six states from which most insurers have completely withdrawn. Insurers that have remained in these states have increased premiums 200% to 2000%. The rest of the country is experiencing only moderate availability problems although fewer insurers are in the market than previously. Every state is experiencing affordability problems. Premium increases are substantial, even on risks with no losses. Larger deductibles or self-insured retentions are being offered or mandated by insurers and the norm is the claims-made form.

Assisted Living Liability Market. As most residents in assisted living facilities are ambulatory, these facilities have not been as great a target for lawsuits. Although affordability issues exist in every state, coverage availability problems are not as pervasive as in skilled nursing. Soft Market premiums were inadequate for the associated risks because insurers, fully understanding the risks associated with skilled nursing, were not similarly prepared for changes rapidly taking place in assisted living. Many states expanded

[9] Arkansas Business, February 4-10, 2002 issue.
[10] Arkansas Department of Insurance News Release, dated March 18, 2002.
[11] St. Petersburg Times, February 14, 2001 issue.
[12] Florida Naples Daily News, February 26, 2002 issue.
[13] Philadelphia Business Journal, March 4, 2002 issue.

the scope of care permitted under various assisted living licenses, but the assisted living industry, in part, was not fully prepared to deliver such care or to defend itself if sued. Thus, claims frequency and severity have increased nationally. The trend is expected to continue as evidence by a recent CNA study in which CNA HealthPro, the largest writer of nursing homes and assisted living, found that its loss experience in assisted living is worse than that of its skilled nursing homes.

Adult Care Homes Liability Market. As adult care homes have the same negative factors in place as do nursing homes and assisted living facilities, this class of business is facing both affordability and availability problems. Most insurers no longer write this class due to the inability to generate adequate premium to cover the risk posed by homes licensed for four to 10 beds. Premiums were so small that insurers could not afford to do any significant inspection, loss control or underwriting of the class. In the few states in which some insurers still offer coverage, premiums have risen 100% to 500% causing many operators to go out of business.

B. Local Influences on NHL: Overall, the Subcommittee believes that coverage availability in Arizona is about average when compared to the rest of the nation. Affordability is also about average, but the "average" price is high as it is being driven by losses involving large out-of-court settlements. Insurers are concerned that the baseline for an average claim's settlement is being “dragged upward" as some insurers, afraid of staggering judgments, settle out of court for amounts less than if they had gone to court, but higher than they would have otherwise paid. Also, more admitted insurers are using surplus lines insurers to write coverage on an excess basis. Most insurers are offering only a claims-made form.

In many instances, insurers rely upon the Department of Health Services' (DHS) reports, surveys and inspections to underwrite and price NHL insurance. However, some Subcommittee members perceive that apparently due to inadequate funding and staff shortages, DHS is behind on its inspections and surveys of assisted living facilities. Therefore, the Subcommittee recommends that policymakers consider increased funding for DHS to enable it to more timely perform this important function.

As with the national markets, certain segments of the Arizona NHL market are in worse condition than others as shown below:

Skilled Nursing Home Liability - Arizona. The Arizona skilled NHL market is somewhere in the middle of the national crisis. Arizona's market is not nearly as grave as that of the most troubled states, and the Task Force is not aware of any national insurer that has listed Arizona as a state in which it will not write this type of business. Some insurers have expressed concerns about Arizona's “Elder Abuse Statute” and its “strict liability doctrine.” The market has hardened in Arizona over the last three years. Even before 9/11, underwriting was becoming more stringent; prices were rising rapidly; and, capacity and reinsurance problems were developing. Because rates previously charged in Arizona were lower than in other parts of the country, the current Arizona rate adjustments are more dramatic than in states that already had significantly higher rates. Only a few insurers still write skilled nursing in Arizona. They are: CNA HealthPro, Royal & SunAlliance, AIG-Lexington, American Empire Surplus Lines Insurance Company, Colony, Western World,

Hartford (not-for-profits only), a couple of offshore captive programs, and one or two Lloyds programs. There are rumors of a possible risk retention group forming in the near future.

Assisted Living Facilities Liability Market – Arizona. Arizona's assisted living market is not viewed as favorably as its skilled nursing market by certain insurers writing only assisted living facilities because Arizona's highest level of care license, the "Assisted Living-Directed Care" license, allows for higher scopes of care than these insurers are interested in covering. These insurers believe that with the permission of the resident and/or the resident's family, the attending physician, and the licensed facility a resident could be allowed to "age in place" until death. Uncomfortable with the ability of assisted living facilities to deliver proper care to aging residents, these insurers are concerned about the possibility of indefensible claims. Other insurers, comfortable with skilled nursing, do not have the same concerns, but pay close attention to directed care licensees and charge premiums comparable to skilled nursing home rates. Premium increases have escalated in Arizona over the past three years by 50% to 500% and are more dramatic than in other parts of the country due to the past's artificially low premiums. Excess liability availability and affordability are about the same as for skilled nursing. Insurers currently writing assisted living facilities in Arizona are: CNA HealthPro, AIG-Lexington, American Empire Surplus Lines Ins. Co., Western World, Colony, Hartford (NFP only), Church Mutual, the TIG Group (no Directed Care licensees), an off-shore captive endorsed by the Assisted Living Federation of America and a couple of Lloyds programs.

Adult Care Homes Liability Market – Arizona. The situation for Adult Care Homes in Arizona is grave. Although Arizona's problems are not unique, Arizona's availability and affordability issues are disturbing because Arizona has so many businesses affected. Of the 1,400 assisted living licenses currently issued in Arizona, 1,200 are in the adult care class. Only two insurers, Western World and Church Mutual, will write these risks in Arizona. Insurers have tried to write this business profitably in this State, but have not been successful although they may have increased their rates substantially; insurer after insurer has entered this class, only to leave it in one or two years.

<u>The Subcommittee made the following recommendations (conclusions and/or recommendations that are in addition or beyond the recommendations of the Task Force appear in **bold**):</u>

- The Department should enhance its existing MAP as previously described to combine the use of the ADOI's website, telephone Hotline, and consumer information seminars with the efforts of a loss control committee, a producer advisory council, the Surplus Lines Association, the Independent Insurance Agents & Brokers Association of Arizona (IIAB) and the insurance companies writing in Arizona. The enhancements should improve consumer education, provide direction to consumers needing it, and result in coverage being placed.

- **In addition to incorporating an educational enhancement into the MAP, the Subcommittee believes the Department should develop, together with the IIAB and other interested parties, an aggressive consumer education program that addresses such topics as:**

- **Risk management, including discussions of arbitration agreements, shared risk agreements and how a risk may defend itself in court.**
- **Loss control and safety.**
- **Insurance terms to include: "what is the difference between occurrence and claims-made," "what is a captive," and "what is the difference between an admitted and an excess and surplus lines insurer?"**
- **How a consumer can present the consumer's risk to the insurance market in order to get the best coverage and pricing available**.

- **The only way to ultimately bring insurers back to the NHL market is by making NHL risks more attractive. A way to do this is to ensure that the legal atmosphere is stable, reasonable and predictable. While the Subcommittee recognizes that amending laws can be time-consuming and costly and that a change in the Arizona constitution may be required, the Subcommittee believes the Legislature should consider:**

  - **Making changes to Arizona's current Elder Abuse Statute to possibly create a better legal climate.**

  - **Enacting tort reform in the form of caps on claims for non-economic damages and limiting punitive damage awards.**

- **The Subcommittee recommends that policymakers consider increasing DHS' funding to enable that agency to produce more timely inspections and subsequent reports**.

- **The Subcommittee recommends that the Legislature consider legislation to prohibit government surveys and/or inspection reports from being entered into evidence in lawsuits.**

Section II. Medical Malpractice: Based on the Medical Malpractice Subcommittee's report, **Exhibit 17**, and other information provided to it, the Task Force found:

A. National and Industry-Wide Influences on Medical Malpractice: Throughout the country, physicians and hospitals are having difficulty finding and affording coverage. Some physicians are retiring early or reopening their practices in more favorable locations. For example, the medical liability crisis has driven many neurosurgeons as well as a new medical center out of Mississippi to Louisiana, which has tort reform laws.[14] Insurers do not want to write in a litigious state primarily due to the difficulty in predicting the ultimate payout on a claim if the state does not have caps on awards.

The St Paul Group, once the largest writer of medical malpractice in the country, announced in 2001 that it would no longer write coverage due to "poor loss history." Other insurers, following its example, have either

[14] BestWeek, August 26, 2002, p5.

voluntarily left the market or have been forced out due to insolvency (e.g., PHICO once a large medical malpractice writer is in liquidation in Pennsylvania). The remaining insurers in the market have severely restricted their writings, raised their prices, and/or limited the coverage they will provide.

State legislators and others are taking different approaches or applying a combination of approaches including, but not limited to, the following:

- Issues of cost and availability have impacted some states more dramatically than others. Arkansas, Florida, Mississippi, Nevada, Ohio, Pennsylvania, Texas, and West Virginia have been the most severely affected. Action to meet the challenges has been taken in some states. Nevada and West Virginia have created insurance pools to make coverage available. Thirty-one smaller rural hospitals in Pennsylvania have joined in the Community Hospital Alternative for Risk Transfer Program (CHART) through a risk retention group.

- Medical malpractice premiums have increased primarily due to increasing litigation and the costs of defending cases in court. Tort reform to limit the amount of jury awards in medical negligence lawsuits is being considered by some legislatures. Expanded theories of liability such as Elder Abuse and Loss of Chance are also contributing to premium increases.

- According to AM Best's compiled data, financial results for medical liability insurers deteriorated in 1999 and 2000 and results are expected to continue deteriorating in 2001 as well. Based on AM Best's final figures, the 2000 countrywide combined ratio of 130% for medical malpractice insurers reached 153.3% in 2001.

- Insurers are experiencing difficulty obtaining reinsurance for coverage provided to hospitals and physicians. Reinsurance for hospital coverage, in particular, is problematic as hospitals seek higher liability limits which reinsurers, on both a treaty and facultative basis, view as increasing the potential for claims severity and, therefore, increase their pricing accordingly. Reinsurers have also placed limitations on coverage terms and conditions, have increased retentions or deductibles, and have reduced limit of liability offerings.

- In addition to increased premium levels, hospitals as well as physicians are experiencing a decrease in reimbursement, which has motivated some hospitals to make business decisions to limit or eliminate services (e.g., obstetrics and higher risk medical/surgical services).

- It is expected that the current Hard Market will last longer than previous ones. Lower liability limits, restricted aggregates, tightened coverage terms and higher prices will continue. The reinsurance market consolidation is likely to continue, resulting in less quality reinsurance sources. Fewer resources and increasing severity levels will translate into higher costs, ultimately passed on to consumers.

- The American Medical Association is lobbying Congress to consider national medical liability reform.

B. Local Influences on Medical Malpractice: The Task Force found that in Arizona the physician and surgeon's medical professional liability market:

- Is dominated by MICA, but other insurers, admitted or surplus lines, also will provide coverage.

- Is stable in comparison to other jurisdictions.

- Has hardened over the past year due to several foreign insurers withdrawing due to financial imperatives or business decisions to exit.

- Poses more coverage affordability than availability concerns for consumers. Availability of coverage is not the most significant issue, but for Arizona physicians previously insured with an exiting insurer, obtaining coverage at the prior premium level is not possible.

- Has also developed deteriorating loss experience, but not to the same extent as in other jurisdictions. Arizona's loss severity levels continue to increase, but its claim frequency reflects only a slight increase. In the immediate future, claim severity will drive rate increases. As claim severity impacts an insurer's reinsurance program, reinsurance costs will continue to increase and will factor heavily into pricing. Insurance premiums are expected to continue to increase.

Based on its review, the Subcommittee made the following recommendations (conclusions and/or recommendations that are in addition or beyond the recommendations of the Task Force appear in **bold**)**:**

- Speed To Market. Arizona's "use and file" law currently provides a system by which insurers can get their products to market faster than if the system were a "prior approval" or "file and use" rate-filing system. The Department should continue to support “speed to market” efforts by further simplifying the rate and rating rule filing process (e.g., uniform filing transmittal forms, filing review checklists, etc.).

- Market Assistance Plan: The Subcommittee considered the State of Washington's MAP and also reviewed potential alternatives to the ADOI's current MAP. The Washington MAP requires administrative review of insurance applications and presentation of applications to participating insurers that voluntarily participate. While the Washington model would create more operational levels to be administered, it would not, in the opinion of the Subcommittee, provide a distribution or underwriting system that would increase medical malpractice coverage availability or address the issues of affordability. The Subcommittee believes a more effective measure would be to enhance the Department's existing MAP by providing educational information to the public and direct links to insurers writing coverage in Arizona as follows:

    - Educational Enhancements To The MAP: The Department should make available the following items to the public:

- A glossary of Insurance terms common to the line of business.
- Questions and answers to test and improve the consumer's knowledge and to provide the consumer with the appropriate tools to evaluate carriers.
- An ADOI "Watch List" that lists insurers that have violated the law or that are currently a subject of regulatory oversight due to their financial condition.

- ADOI Website enhancement and promotion: The purchasers of medical professional liability coverage, primarily physicians, surgeons and hospitals, are, for the most part, well-informed purchasers of the coverage. However, a limited number of physicians and facility administrators may not be familiar with all available markets. In those lines or subjects of insurance where availability of coverage may be an issue, the Task Force believes that the ADOI Website should include features relating to specific markets. For Medical Professional Liability, these special features might include:

    - All of the previously described educational enhancements.
    - A current listing of insurers, together with phone numbers or web links to:
        - Admitted Carriers,
        - Excess and Surplus Lines,
        - Arizona domiciled Captives, and
        - Producer and/or Insurer Associations.
    - Links to Risk Management/Loss Prevention Information.
    - Links to insurers or recourses within the industry.
    - A link to AM Best for reviews of insurers.

- Legislation. **The Subcommittee recommends the Legislature consider the following.**

- **Title 20, Chapter 4, Article 14, recently enacted, permits captives to be formed in Arizona. However, further consideration should be given by the legislature to increasing the attractiveness of such programs. For example, through legislative enhancements to the law, the features provided in "off-shore" models could be applied to Arizona. These features might include single cell or protected cell captives to segregate risk and control administrative overhead costs. Expense factors should also be evaluated in order to equalize cost structures to those operating "off-shore."**

- **In addition to the enhancements to the captive law described above, legislators should also consider the following issues which can, depending upon the answers, deter insurers from operating in the Arizona market:**

    - **Should the statute of limitations be revised? The Arizona Supreme Court's ruling in *Walk v. Ring*: CV-01-0090-PR effectively negated the statute of limitations on medical liability cases. The court ruled that the question of whether a plaintiff knew or should have known more than**

two years before a filing whether an injury "had been wrongfully inflicted" is a matter for the jury to determine.

- **Should corporations or other entities be held directly liable for their own negligence, recklessness and other tortuous conduct in hiring and supervising the corporation's or entity's officers, employees, agents and contractors whose conduct gave rise to the incident for which suit is being brought?**
- **Should remedies available under the medical malpractice act be strictly separated from remedies available under Arizona's elder abuse act?**
- **Should Arizona impose caps on non-economic damages?**

Section III. Construction Defects: The Subcommittee in its report (**Exhibit 18**) found:

A. National and Industry-Wide Influences on Construction Defects: Nationally, numerous lawsuits, many of which also include mold issues, have been filed alleging construction defects. See **Exhibit 19** for a sampling of lawsuits as of August, 2002. In some states, the demand for construction has exceeded the supply of skilled laborers. Insurers are encouraging builders to implement more stringent loss control and safety procedures.

In addition to Arizona, other states are also experiencing similar problems with builders having difficulties in obtaining construction defects insurance. Nevada, in particular, has been affected and that state is attempting to form a state insurer for the purpose of providing subcontractors with insurance.

B. Local Influences on Construction Defects: Arizona's experience appears to reflect the national scene. More construction defects lawsuits are being filed, and more construction defects lawsuits include mold matters.

In Arizona, contractors have engaged in a flurry of building to meet mounting consumer demand for new residential construction. Some construction defects losses were inevitable, and the ensuing lawsuits which resulted have, in turn, lead to the current problems being experienced by contractors in obtaining construction defects insurance.

Specifically, during the past six to 18 months, it has become increasingly difficult for Arizona land developers, general contractors and artisan contractors to obtain contractors general liability and excess liability insurance coverage. Residential contractors involved in building multi-family structures (e.g., condominiums or townhouses) or tract homes are the most affected. Those few insurers that will offer the coverage have dramatically increased their rates, are excluding "known loss" from the policy, and are restricting coverage terms. Some competent contractors, either unable to afford or find the coverage they need or want, are being forced out of business. Except in a few classes, affordability is the problem rather than availability. However, even in the most difficult classes (e.g., contractors who do framing, concrete

work, window installation, and/or stucco work), there are a few insurers that will cover the risk although on a restricted basis.

Limited coverage availability can be directly attributed to how Arizona courts consider the insurance policy and the number of lawsuits filed and size of insurer payouts involved. For example, some courts have treated the general liability policy and the excess policy as warranty policies. Additionally, in well-publicized accounts in April, 2002, three homeowners' associations in Chandler received judgments and settlements totaling $11 million.[15]

Some insurers have settled causing builders to allege that insurers make business decisions to settle because it is cheaper than engaging in lengthy court battles that consume their time, funds, and limited human resources. In particular, class action suits have the potentiality of becoming more costly as many more homes are subject to damage payments. Builders hope that HB 2620, effective August 22, 2002, requiring homeowners to give builders detailed written notice of problems and at least 60 days to respond before filing or proceeding with a lawsuit will reduce the number of lawsuits.

However, lawsuits claiming construction defects and involving more than 3,000 homes are still moving through Maricopa County Superior Court.[16] Frequent issues involved in these lawsuits are:

- What does the definition in the policy of "occurrence" mean?
- Who is responsible?
- How is liability transferred to other parties?
- How many insurance policies will respond?

These common lawsuit issues have caused insurers to further restrict policy language and to pare down coverage.

The Subcommittee made the following recommendations (conclusions and/or recommendations that are in addition or beyond the recommendations of the Task Force appear in **bold**):

- **Explain to the public, through educational programs or materials furnished by insurance industry trade associations, what constitutes a "construction defect."**

- **Educate the construction industry, through AHA-sponsored educational programs, how to reduce construction defects and police its own members.**

- **Assist the legislature, through educational materials provided by insurance industry trade associations, in understanding the intent of the contractual**

[15] "Builders Settle Defect Claims," Arizona Republic, April 13, 2002 (East Valley Edition).
[16] "Defects Build Bad Blood," Arizona Republic, August 16, 2002.

liability insurance and, in particular, premises/operations and completed operations coverage applicable to construction defects so that future laws addressing workmanship and contractual exposures involving construction defects are well-defined so as to avoid erroneous interpretations by courts.

- **The legislature should:**
  - **Increase funding for the Registrar of Contractors so that office may work with homeowners and contractors to resolve issues and mitigate disputes without homeowners having to file lawsuits.**
  - **Consider legislation to identify that a mold loss cannot occur as a result of poor housekeeping.**
  - **Consider further enhancement of HB 2620 to incorporate a comprehensive package that includes tort reform and that would incorporate some statutory definitions that would be of help to courts in trying to interpret commercial general liability policies.**